Middle Market Update

2nd Quarter 2015

Second Quarter Economic Performance and Future Outlook

Gross Domestic Product

- Real GDP grew 2.3% in Q2 2015, up from the 0.6% increase in Q1 2015, yet short of the consensus estimate of 2.6%[1]
- The growth in GDP reflected primarily an acceleration in consumer spending and an upturn in exports, residential fixed investment, and municipal government spending[1]
  - Despite a strong dollar, real exports of goods and services increased 5.3% in Q2 2015, in comparison with a decrease of 6.0% in Q1 2015
  - Real residential fixed investment jumped 6.6% in Q2 2015, a slowdown from the 10.8% growth in Q1 2015
  - Real state and local government consumption expenditures and gross investment expanded 2.0% in Q2 2015, in contrast with a decrease of 0.8% in Q1 2015

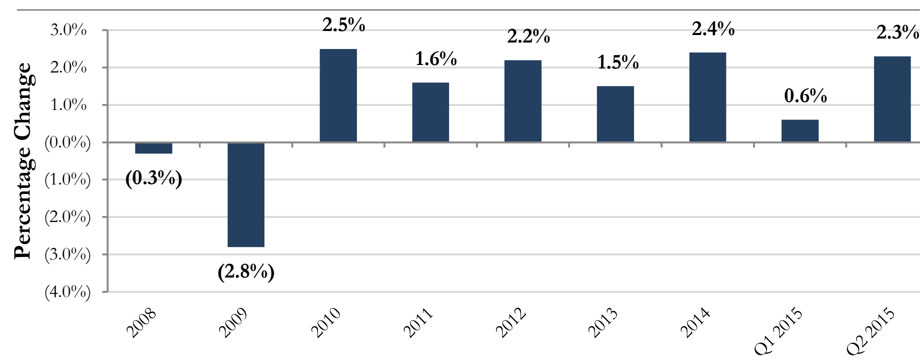
Consumer Spending

- Consumers were net spenders this quarter, as real disposable personal income grew 3.7%, up from 1.8% in Q1 2015, while the personal savings rate declined from 5.2% to 4.8% in Q2 2015[1]
  - Real personal consumption expenditures rose 2.9% in Q2 2015, an increase from the 1.8% growth recorded in Q1 2015
- Personal income climbed $145.0B in Q2 2015, as compared with $118.9B in Q1 2015, reflecting upturns in personal interest income and in farm proprietors' income, partly offset by decelerations in government social benefits and personal dividend income

Outlook for H2 2015

- U.S. CEOs have lowered their sales projections and plans for capital investment and hiring in H2 2015, reflecting concerns about the continued sub-par growth of the U.S. economy[2]
  - Business Roundtable members expect GDP growth of 2.5% in 2015, a decrease of 30 bps from their consensus in the previous quarter

Real GDP Growth Since 2008



Source: Bureau of Economic Analysis.

Employment

- The unemployment rate slid from 5.5% in May 2015 to 5.3% in June[3]
- The decrease is partially explained by the drop in the labor force participation rate, reaching 62.6% - its lowest level since October 1977, as discouraged workers and baby boomers are exiting the labor force[3]

U.S. Treasury Securities

- After several quarters of flattening, the treasury yield curve steepened sharply in Q2 2015, as long-term maturities moved higher by more than 50 bps[4]

	Q3 2014[5]	Q4 2014[5]	Q1 2015[5]	Q2 2015[5]
5-year Treasury Note	1.9%	1.7%	1.4%	1.7%
10-year Treasury Note	2.7%	2.3%	2.0%	2.4%
30-year Treasury Note	3.4%	2.9%	2.7%	3.4%
10-year Treasury Inflation Protected Security (TIPS)	0.6%	0.5%	0.2%	0.5%

Federal Reserve

- Despite economic stagnation and reduced labor participation, the FOMC views the disappointing economic performance to be largely transitory, and believes household spending and solid consumer sentiment will contribute to positive GDP growth[6]

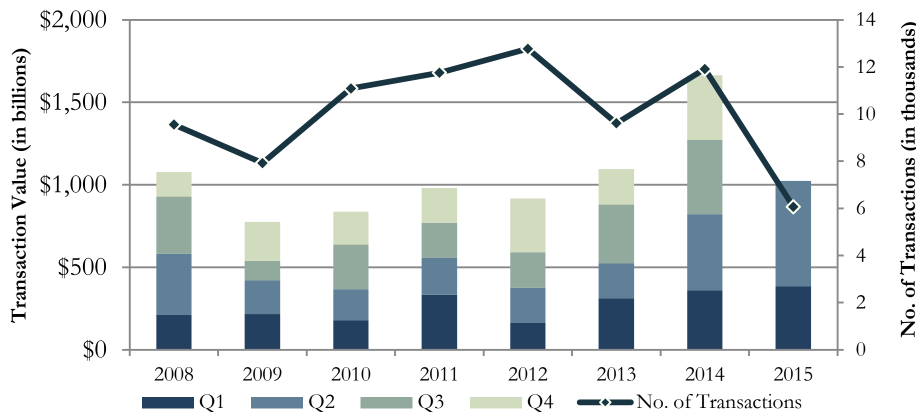
1. *U.S. Bureau of Economic Analysis*
2. *CEO Economic Outlook Survey published by Business Roundtable*
3. *Bureau of Labor Statistics*
4. *R.W. Baird*
5. *U.S. Department of the Treasury*
6. *U.S. Federal Reserve*

Mergers and Acquisitions and Private Equity

Aramar Capital Group, LLC

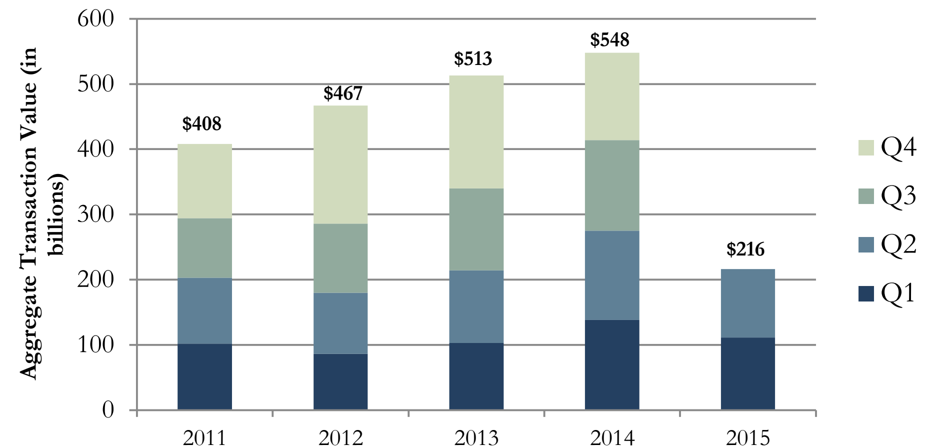
- The aggregate global M&A transaction value rose 15.2% to $1.7T in H1 2015, as compared to $1.5T in H1 2014[1]
- The U.S. accounted for 42.7% of the global deal value[1]
  - U.S. M&A transactions in H1 2015 ended at $740.6B across 2,083 deals, an increase of 23.8% in value compared with $598.2B in H1 2014
  - Mega-deals, such as Charter Communications' $77.8B acquisition of Time Warner Cable, contributed 18.8% of deal value in Q2 2015, and led the technology, media, and telecom sector to jump 45.4% to $238.1B across 460 deals in H1 2015 versus the same period in the prior year
- Low interest rates, significant corporate cash balances, a hunger for acquisitive growth into new segments and potential synergies, and sustained high stock prices fueled the M&A shopping spree through H1 2015[2]
- The global private equity market is projected to reach $6.5T to $7.4T by 2020, as sovereign wealth funds and high-net worth individuals are seeking alternative investments as a way of diversifying holdings and decreasing correlation with the stock and bond markets [3]

U.S. M&A Activity



Source: FactSet U.S. Flashwire January Report.

U.S. Private Equity Deal Flow



Source: PitchBook.

- PE deal flow fell 21.5% from 1,753 deals in H1 2014 worth $275B to 1,509 deals worth $215.9B in H1 2015, as PE firms fear today's high multiples may lead to stunted returns in the next four years[2]
  - The U.S. PE investment-to-exit ratio hit a decade-low 1.7x in H1 2015, with the majority of exits made to strategic buyers
  - The total value of all PE-backed exits reached $185B in H1 2015, already 70.0% of the total value exited in all of 2014
- 48.0% of all H1 2015 PE deals were under $25M, indicating a shift towards the lower-middle market[2]
- Valuations of PE-acquired companies decreased overall from 2014, but experienced improvements for middle-market transactions:
  - The median total enterprise value (TEV) to EBITDA multiple fell to 7.3x in H1 2015, down from 10.0x in 2013-2014[2,4]
  - Valuations for companies in the $10M to $250M TEV range averaged 6.7x trailing adjusted EBITDA in H1 2015, up 4.7% from the 2014 average of 6.4x[5]
- PE firms had $1.32T of dry powder as of June 30th (roughly equivalent to Mexico's GDP)[6]

1. *Mergermarket*
2. *PitchBook*
3. *PWC*
4. *These multiples reflect prices paid for mainly public companies and do not account for smaller private company transactions (for which there typically are no publicly available data) that tend to change hands at much lower multiples*
5. *GF Data*
6. *Preqin*

Venture Capital and PIPEs

Aramar Capital Group, LLC

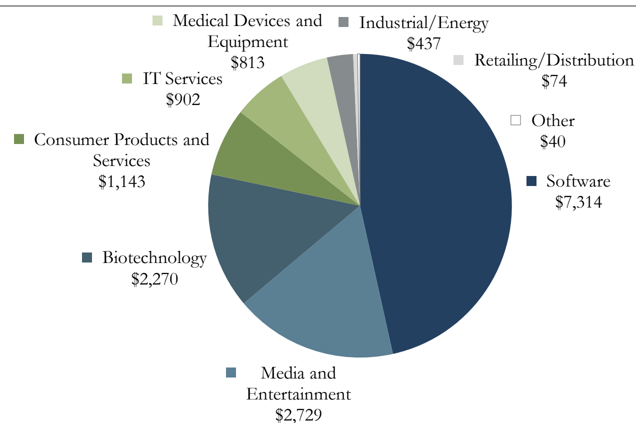
Venture Capital Investing

- In Q2 2015, the venture capital (VC) industry invested $17.5B across 1,189 deals, an increase of 30.0% in value and 13.0% in number, as compared with $13.5B across 1,048 transactions in Q1 2015[1]
- First-time financings swelled 43.0% from $1.8B in Q1 2015 to $2.6B in Q2 2015, while the number of deals rose 18.0% from the prior quarter[1]
- There were 27 VC-backed IPOs in Q2 2015 totaling $3.4B, a 59.0% increase in the number of offerings and more than double the level of dollars raised during the prior quarter[2]
- U.S. VC firms raised $10.3B across 74 funds during Q2 2015, a spurt of 10.0% in fund count and 39.0% in total dollar commitments in contrast to Q1 2015[2]
  - VC dollar commitments during Q2 2015 climbed 27.0% compared with Q2 2014, marking the strongest quarter for VC fundraising since before the recession
  - The top fundraiser during Q2 2015 was New Enterprise Associates 15, L.P., which raised $2.8B

PIPE Investing

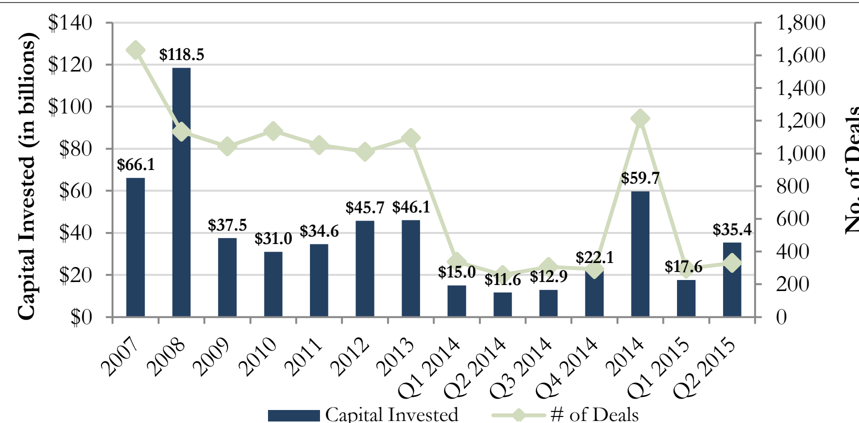
- $53B was taken in across 626 PIPE transactions that were announced or completed in H1 2015, doubling in value from the $26.5B raised across 595 transactions in H1 2014[3]
  - The lack of attractive IPO prospects in Q2 2015 contributed to the significant growth in the PIPE market, as new participants sought to invest in large cap companies offering a comparable degree of liquidity and stability
  - Additional growth in the PIPE market was partly driven by companies that went public in recent years in less successful IPOs, making them unable to generate demand for follow-on offerings
- Sabby Management LLC was the most active institutional investor in Q2 2015, with 13 private placements amounting to $43.5M[3,4]
- Calm financial markets played an additional role in driving deal flow, as relatively low volatility allowed investors and PIPE-issuing companies to come quickly to terms[3]

VC Deals Per Industry – Q2 2015 (in millions)



Source: MoneyTree Report.

U.S. PIPE Activity



Source: PrivateRaise/DealFlow.

1. *MoneyTree Report by PricewaterhouseCoopers LLC and the NVCA*
2. *Thomson Reuters LPC*
3. *Private Raise/Dealflow*
4. *Excludes transactions for which the investment amount has not yet been disclosed*

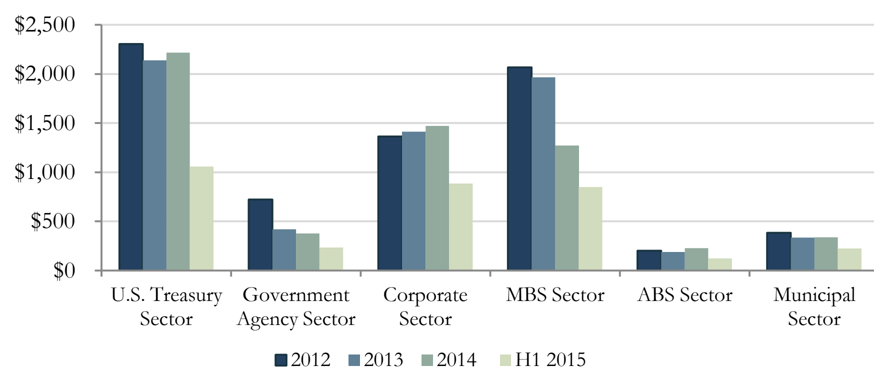
Debt Capital

- The Barclays U.S. Aggregate Bond Index posted a negative 1.7% return in Q1 2015, down from a positive return of 1.6% in Q1 2015[1]
  - The aggressive bond sell-off witnessed in Q1 2015 may be attributable to the ECB's implementation of its QE program, diminishing liquidity and exacerbating market volatility
- The Barclays U.S. Corporate Bond Index posted a negative 3.16% return in Q2 2015, primarily as a result of a surge in new issuance, a spike in M&A, and a rise in U.S. Treasury yields[1]
  - U.S. corporate spreads over similar maturity Treasuries rose 16 bps from 129 bps in Q1 2015 to 145 bps in Q2 2015
- Total debt issuances increased 3.7% from $1,616.2B in Q1 2015 to $1,676.8B in Q2 2015[2]
  - The overall growth was driven by a 27.0% escalation in mortgage-related bond issuances, up to $441.2B from $347.5B in Q1 2015, largely attributable to unprecedented growth in U.S. housing starts
  - Federal agency securities issuances decreased 34.9% from $136.7B in Q1 2015 to $95.5B in Q2 2015
- The high-yield bond market posted modest returns in Q2 2015, as the extreme weakness in June stemming from market volatility and Greece's growing default risk weighed on sentiment and cut back on earlier positive returns[3]
- The Barclays U.S. Corporate High Yield Index was higher by 65 bps in June versus May, finishing the month at 6.57%, its highest level since January[4]

Middle-market Loan Issuance

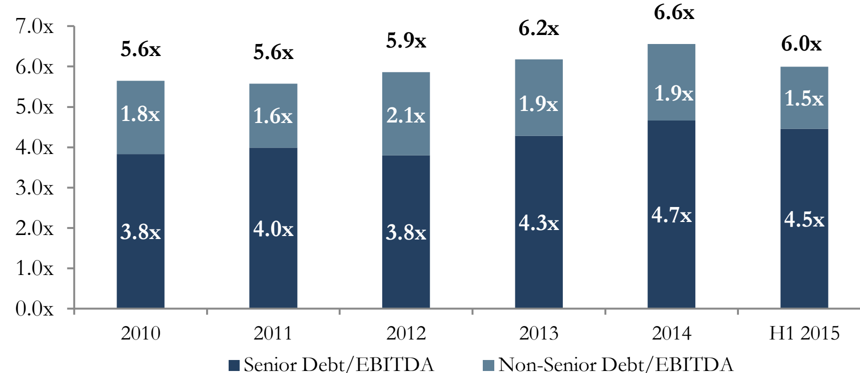
- Middle-market yields ticked lower to 6.0% in Q2 2015, down from 6.7% in Q1 2015[4]
- Leverage multiples decreased in H1 2015, following four years of consecutive growth[4,5]
  - The average debt to EBITDA multiple decreased in Q2 2015 to 6.0x for broadly syndicated LBOs and 5.3x for institutional middle-market LBOs
- Middle-market lending stood at $65.5B for H1 2015[4], with 27.5% for transactions under $100M and 62.5% in the $100-500M range
  - Senior debt pricing improved, precipitating a steady drop in the average equity share over the past two years from 48.1% in 2013 to 43.0% in H1 2015[6]

Issuance in the U.S. Bond Market (in billions)



Source: SIFMA.

Debt Multiples of Middle-Market LBO Loans



Source: Thomson Reuters LPC.

1. *Prudential Financial*
2. *SIFMA*
3. *Guggenheim Partners*
4. *Thomson Reuters LPC*
5. *These multiples mostly reflect prices paid for larger private companies and generally do not account for smaller private company transactions that tend to change hands at much lower multiples and with lower debt ratios*
6. *GF Data*

The Cash King Is Dead. All Hail the New King: Debt

2015 U.S. Working Capital Survey
By REL, a division of The Hackett Group

Corporate debt continues to skyrocket, as companies do little to generate cash by optimizing collections, payables, and inventory. Debt rose by over 9% in 2014 to nearly $4.6 trillion, with companies leveraging low interest rates to fund increased investment activities. At the same time, companies once again made almost no improvement in their working capital management, doing little to generate cash internally by optimizing how they collect from customers, pay suppliers, and manage inventory.

Cash flow lessons not learned from the Great Recession

The cash conversion cycle (CCC) once again remained flat in 2014, only improving one day since 2007. Cash on hand continued to increase, improving 74% over the same period. Even though revenue has increased 39%, debt continues to be a source of investment, rising by a total of 62% over the same period. Companies that increased their debt 100% or more since 2007 had a 1,516% increase in cash on hand but their CCC worsened by 113%. The companies that decreased their debt since 2007 had a 336% uptick in cash on hand, but their CCC improved 31%. There is a $1 trillion cash flow opportunity comparing top and bottom performers, with the greatest potential gains available in improved inventory and payables management.

It seems that companies have learned very little from the Great Recession in terms of their cash management strategies, taking on large amounts of debt to fund increased investment activities, while doing very little operationally to improve their own internal cash generation. "Cash is king" has been a traditional mantra, but ironically, given recent history, debt has taken over the reins.

A few quotes from the great Warren Buffet come to mind. "I do not like debt and do not like to invest in companies that have too much debt, particularly long-term debt. With long-term debt, increases in interest rates can drastically affect company profits and make future cash flows less predictable."[1] And, "Cash ... is to a business as oxygen is to an individual: never thought about when it is present, the only thing in mind when it is absent."[2]

Cash, debt, and the cash conversion cycle

The expansion of cash on hand looks like a great improvement and might lead some to believe corporations are hoarding cash, which has been a very common view over the past few years. However, cash on hand should not be analyzed independently; the economy is doing better with revenue increasing 39% over the same period, but cash on hand as a percent of revenue has increased by only 2%. Companies have been applying much of their excess cash to dividend payments, M&A activity, and share buy-backs.

So there clearly is more cash available and it's being spent. But where is it coming from? We established above that debt is a large contributor, rising 62% since 2007 to the tune of $4.6 trillion, while the federal funds rate declined from 5% to 0.09%. Executive leadership has taken advantage of these low borrowing costs, often rewarding shareholders through dividends or directly in the share price through share buy-back programs in the short term. Companies should be very concerned about the long-term risks such as over-leveraging, liquidity, changes in interest rates, cash apathy, and a general dependence on debt; and they should be managing appropriately to mitigate those risks where possible.

1. *http://www.minterest.org/best-warren-buffett-quotes-on-investing/*
2. *http://www.fool.com/investing/general/2015/03/29/warren-buffett-3-ways-to-protect-your-savings-from.aspx*

However, the consistently flat CCC since 2007 suggests companies are doing very little to mitigate these risks through operational cash flow improvements. Such improvements in the CCC reduce the amount of time each dollar is tied up in the buying, production, and sales process before it is converted into cash through sales to customers. The lower the CCC, the better. Some companies even strive to achieve negative CCC, where the product is made and customer cash is received before suppliers are paid. Think end consumers paying for the Apple Watch™ before they receive it – Apple's CCC is an incredibly great *negative* 56 days. The CCC has improved only one day since 2007 (-3%), and there were recently only 30 companies whose executives mentioned the CCC in their Q1 2015 earnings transcripts[3], confirming Mr. Buffett's comments above.

Companies focused on cash management are in great cash health

Not all companies are completely ignoring cash flow management. Ninety-six companies (10%) improved their CCC every year for the past three years. Yet, as we expand that time frame, we find fewer and fewer companies really able to consistently improve, suggesting after three years the weeds begin to grow back. There are only five companies that improved their CCC every year since 2007 (Amerisource Bergen, Diebold, EQT, Goodyear, and Masco). These companies have seen a substantial improvement in their cash metrics since 2007 vs. the entire REL 1000, with over 200% greater cash on hand, 7% more cash on hand as a percent of revenue, 20% higher capital expenditures, 21% less debt, and a 171% improvement in the CCC. We believe the debt gap would have been even larger, but two companies doubled and tripled their assets, suggesting an aggressive expansion/acquisition strategy.

Companies with large amounts of debt apathetically ignore cash management

Further expanding this analysis to a larger sample size, and analyzing based on the amount of debt incurred, also yielded some interesting results. There were 219 companies with any reduction in debt, no matter how large or how small; from 2007 to 2014, these companies had a 31% average reduction in the CCC and 336% increase in cash on hand. The 328 companies that increased their debt 100% or more from 2007 to 2014 had an average 113% rise in the CCC and a decrease of 1,500% in their debt coverage ratio, but a 1,516% jump in cash on hand. So the companies with the largest increases in debt also had the largest uptick in cash on hand, but apathetically ignored their own ability to generate cash independently.

These figures bring some interesting questions to the forefront for corporate leadership and investors to consider. Is there really an abundance of cash? Has the Great Recession taught U.S. companies anything about the importance of cash reserves? How much longer can cheap debt be the source of investment activity? Have corporations borrowed too much? When is the Federal Reserve going to raise interest rates? What is the long-term impact of all this debt? How are companies proactively managing, if at all?

Not all industries are equal

The latest REL 1000 study has identified an opportunity gap between top performers and bottom performers by industry totaling $1 trillion. While all three areas of working capital offer improvement potential, the largest performance gaps in 2014 lie in inventory and payables.

3. *http://seekingalpha.com/search/transcripts?term=%22cash%20conversion%20cycle%22&all=true*

Some select industries have improved their performance over the past year. Technology hardware, having first moved into negative CCC in 2010, has continued to improve with stellar DPO performance in 2014. Biotechnology has seen improved DIO, as inventory management initiatives take effect, while the paper and forest products industry has witnessed an improvement in both inventory and receivables performance. Additional industries have seen working capital performance decline over the past year, including some short term, such as the DSO increase in construction and engineering. Other impacts are symptoms of permanent changes in the marketplace, such as retailer consolidation driving down DSO in the personal products industry, while in the Internet and catalog retailing industry payables performance has continued the downward drift first seen in 2011.

The road ahead

The U.S. economy definitely is enjoying all of the benefits of acceleration. However, the source and apathetic management of cash flow are concerning. In 2015, we expect the trend to continue and debt to grow significantly, as companies take advantage of cheap borrowing costs for what is expected to be the last opportunity for a long while. If and when interest rates are raised, companies focused on optimizing their CCC will be best positioned to mitigate their risk, continue using cash for investment activities, and outperform their peers not only in areas directly related to cash, but also in the downstream elements impacting cost and internal/external service.

Companies wishing to improve their CCC should start by understanding their gaps in each component: receivables (DSO), payables (DPO), and inventory (DIO). Utilizing peer comparisons for similar organizations within the industry is a good place to start when evaluating potential cash flow benefits.

About REL

REL, a division of The Hackett Group, Inc. (NASDAQ:HCKT), is a world-leading consulting firm dedicated to delivering sustainable cash flow improvement from working capital and across business operations. REL's tailored working capital management solutions balance client trade-offs among working capital, operating costs, service performance, and risk. The company's expertise has helped clients free up billions of dollars in cash, creating the financial freedom to fund acquisitions, product development, debt reduction, and share buy-back programs. REL has delivered work in over 60 countries for Fortune 500 and global Fortune 500 companies.

To learn more and download the full research, please visit http://www.thehackettgroup.com/solutions/working-capital-management/

Differentiation

- Aramar Capital Group, LLC is a boutique investment bank focused on providing merger, acquisition, and strategic private placement services. We are unique among our investment banking peers in that:
  - We focus on middle-market transactions; these transactions are a priority, not a default for when larger deals are dormant;
  - We have significant transactional expertise;
  - We offer senior level attention; and
  - We have a proprietary marketing process that follows a comprehensive approach tailored to each buyer or investor candidate, rather than a typical generic approach utilizing "blast" e-mails, letters, and other contacts.

Services

- Aramar offers a highly focused set of corporate finance services to assist our clients in conceiving, defining, executing, and optimizing their objectives:
  - Mergers and Acquisitions
    - Negotiated Sales of Closely-held Companies
    - Corporate and Private Equity Firm Divestitures
    - Leveraged Buyouts
    - Managed Buyouts
    - Buy-side Advisory
  - Private Equity Placements
  - Private Debt Placements
  - Recapitalizations
  - Fairness Opinions
  - Valuations
  - Financial Advisory

Clientele

- Aramar focuses on providing a superior level of service to "middle-market" clients. Our M&A transactions range in size from approximately $10 million to $200 million. Our strategic private placements range in size from approximately $10 million to $100 million.
- We provide the high quality of service and substantial transactional experience offered by a major national investment bank, but to a clientele that either is too small for, or cannot receive, the proper level of attention from a larger investment bank, or would receive lesser services and capabilities from a business broker, consultant, or smaller investment bank. This encompasses access to Aramar's senior professionals and proprietary marketing process.

Team

- Aramar has assembled a unique team of professionals with a comprehensive and attractive mix of skills and experience. This team has significant investment banking experience, including stints at many other prominent financial services firms.
- Equally important, however, our team has entrepreneurial, managerial, and ownership experience that sets apart Aramar's "principal" perspective from that of most investment banks, where professionals tend to act simply as "agents." As principals, our team members have founded firms, acquired other companies, sold and merged our own companies, and acted as officers and directors of both public and private enterprises. As such, we can relate more closely to our clients and better advise them, at the same time as ensuring senior level investment banking attention.